DOW THEORY LETTERS INC.

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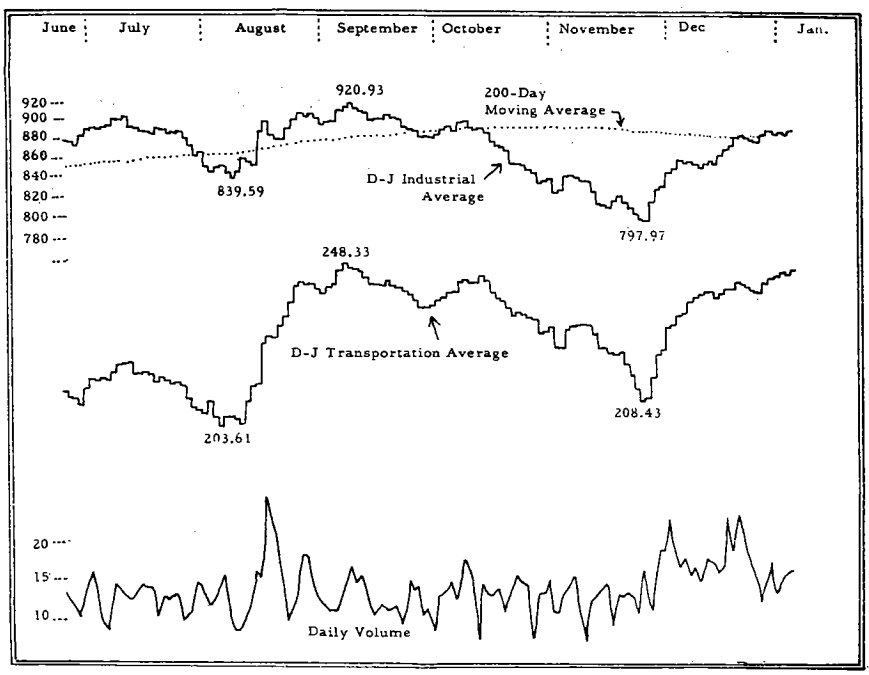
START: I want to start by wishing all my old and new subscribers (total now at the highest level ever) my very best for the New Year. I am including a new page 1 chart with this mailing, and I believe it will be cleaner and easier to read than the previous indicator chart. I have dropped the Eurosyndicat Index because the Amro-Pierson index (page 6) covers the same data.

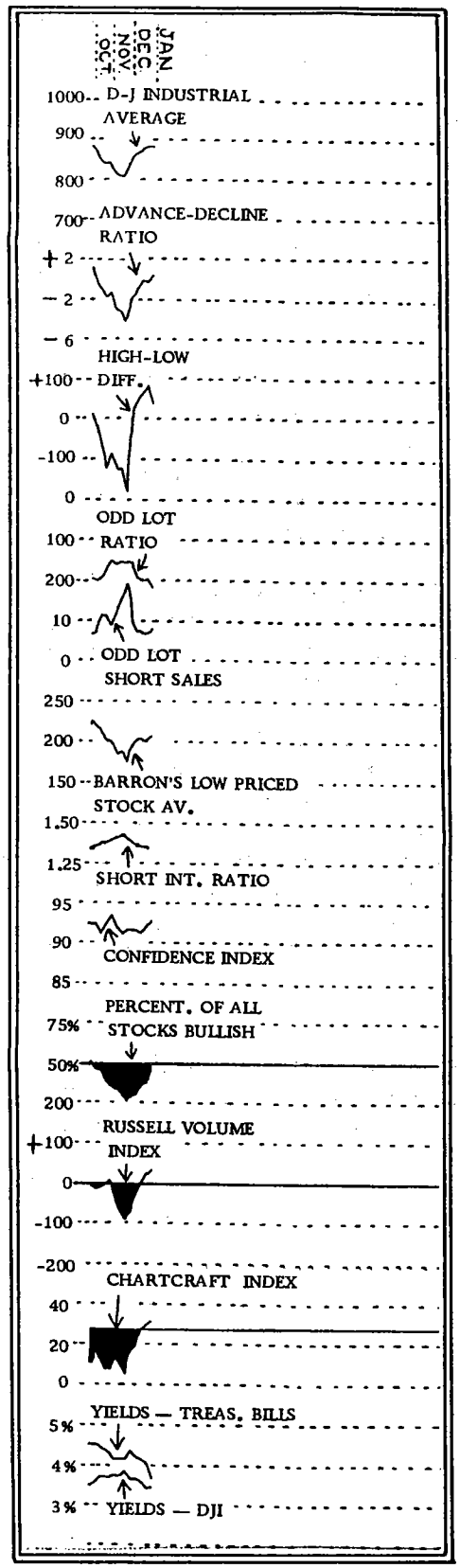
To turn to the current market, I think it is most interesting to note that 1971 required huge, record volume (see chart on page 2) to move this market up towards the 900 level. The fact is that it is requiring more and more fuel under the market "burner" for each successive assault on the 900 level. There have been nine such assaults since the 1966 bull market peak, at which time (1966) it required less than 2 billion shares for the year to take the Dow to its record high of 995.15.

I have also included the "four indicator" chart on page 2, and this is worth studying carefully. Note that the trendline A (Industrials) is still measuring a series of three declining tops, while trendline B (Transports) is defining two ascending peaks. This divergence still exists and constitutes a continuing technical danger to the market.

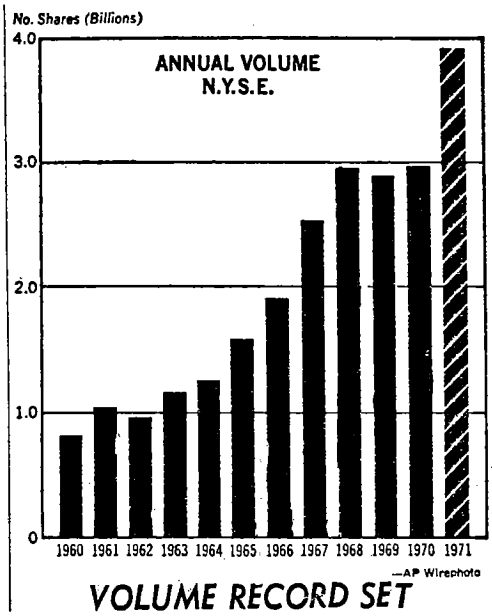
The Advance-Decline ratio is still tracing a bearish pattern with each peak during 1971 below the preceding peak. Finally, the Utility Average (which has bellwether characteristics) has pushed above its October peak, and it remains to be seen whether this constitutes a true reversal or not.

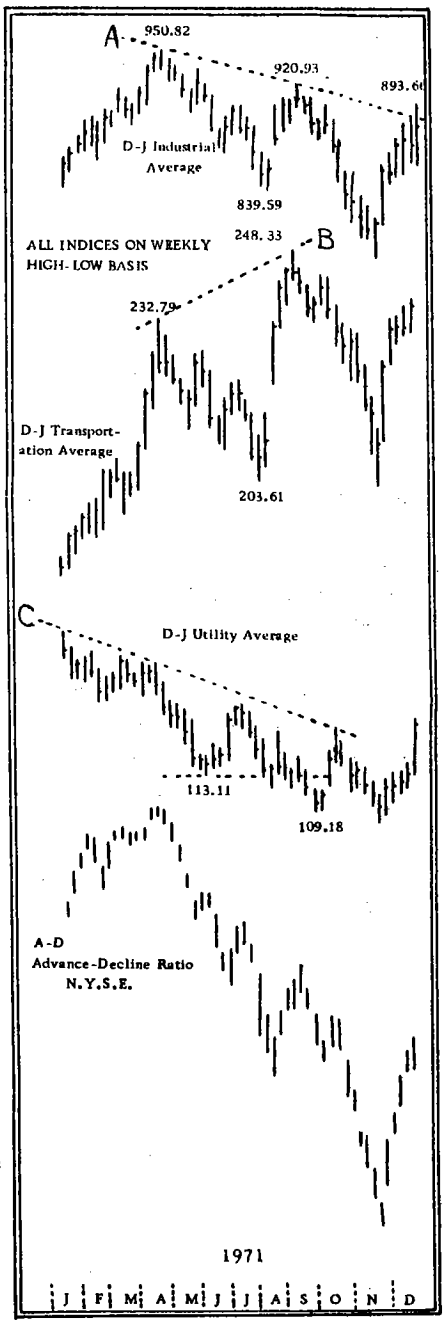
It is notable that the weekly high-low differential (see Barron's) is now dropping with the figure for December 23 (Dow at 881) being 191 and the figure for December 31 (Dow at 890) being 130. The same may be said for the Barron's group high-low differential (see Letter 504) with an index figure of 6 on December 23 and a figure of 4 (with the Dow up 9 points) for December 31. My





daily "most-active stock" index (see Letter 513) also topped out on December 21 at 55 (Dow was then 875) compared with a reading of 26 today with the Dow at 900. All in all, we are at a most interesting juncture, with more and more technical indicators flashing danger signals.



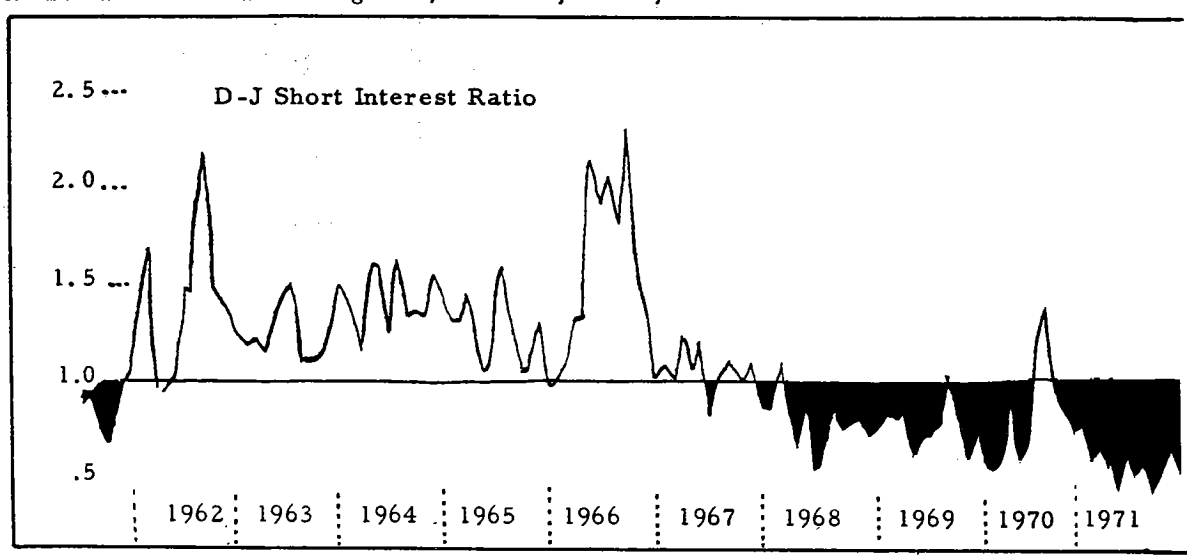


Of course, the big picture is even more fascinating, with one of the most ambitious Presidents in American history going all out to win a second term in the face of a primary bear market which absorbs record volumes of stock year after year while steadfastly refusing (in the face of every kind of Government stimulation) to "go through the roof". The power of Mr. Nixon or the bear may be gauged by the following: Mr. Nixon took office on Jan. 20, 1969, at which time the Dow stood at 931. Now, three years later (having been as low as 631), the Dow is still around 30 points below the point at which Mr. Nixon took office.

In concluding this section, it might be well to remember that it is typical of primary bear markets to hit their highs in January or during the first quarter of the new year, and then establish their lows towards the end of the year (which, this year, happens to be election time).

DOW SHORT INTEREST RATIO: Periodically I have included comments on the short interest ratio in the 30 Dow Industrial stocks. This Index (which was developed by William Gordon of New York) is computed in the same manner as the regular short interest ratio which appears monthly in Barron's. The difference, however, is that the Dow Short Interest Ratio (DSIR) is arrived at by computing the total short interest in the 30 Dow Industrial stocks and using this amount as a percentage of the average daily trading volume in those 30 Dow stocks. The regular short interest ratio uses the total short interest on the N.Y.S.E. and takes this as a percentage of the total average daily volume on the N.Y.S.E. for the monthly period.

My studies of both ratios indicate that the DSIR is more accurate than the regular short interest ratio. I have figures on the DSIR going back to 1931 (see Letter 508), and it is notable that the "buy" and "sell" signals provided by the DSIR are both accurate and few and far between. In general, I would say that any time the ratio is

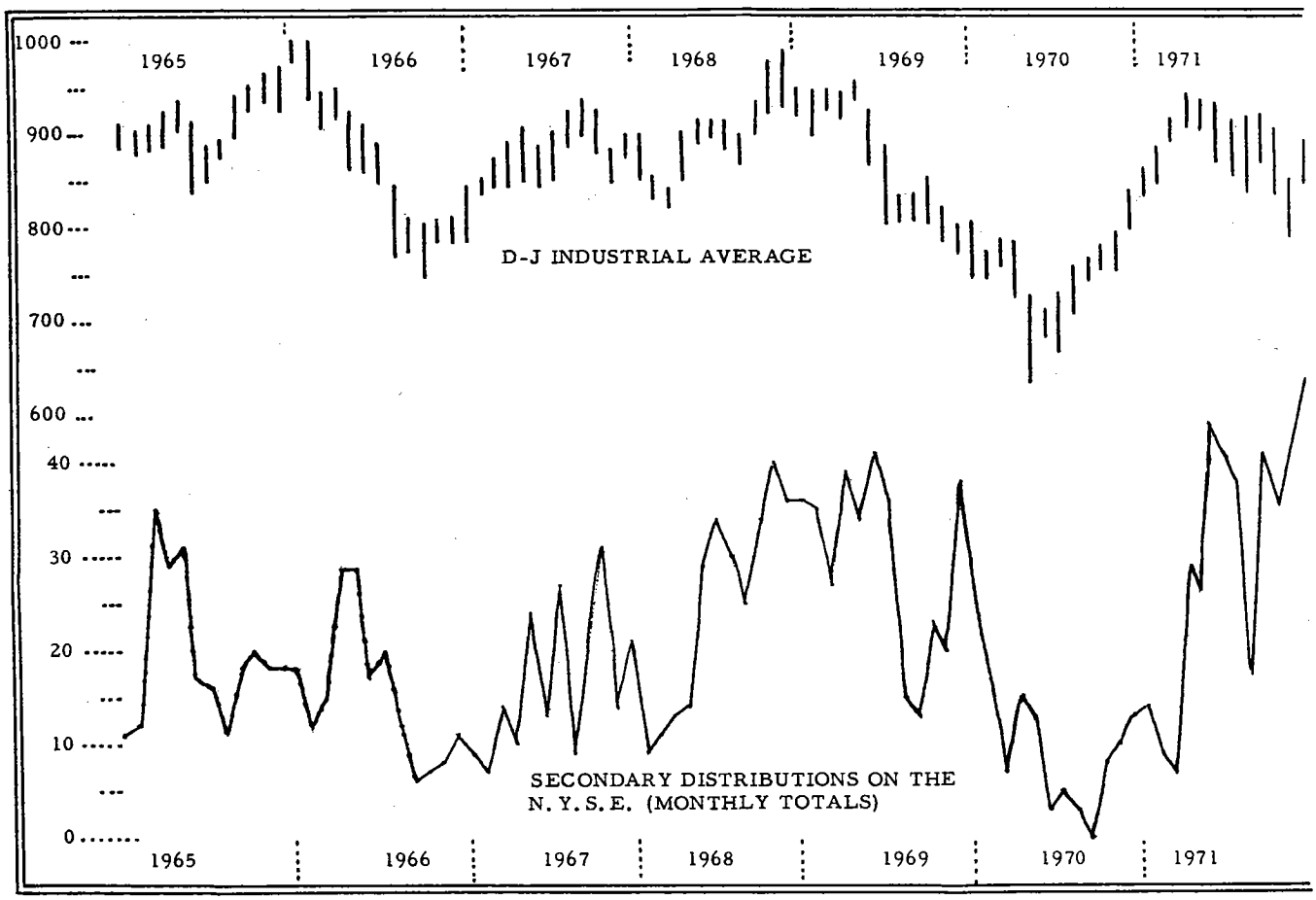


above 2.00, the reading is strongly bullish (particularly when this occurs within a primary bull market). Conversely, any time the reading is under 1.0 the indications are bearish (particularly, as now, when those readings come within the context of a primary bear market).

Note on the chart (page 2) that the black (under 1.0) or bearish zone began during 1968 and continued to give its warnings all through the year. This was followed by the market collapse of 1969-70. During 1970 there was a sub-standard build-up in the DSIR as the ratio reached a 1970 high of 1.40. The Dow, under the impetus of massive Governmental stimulation, rose to a 1971 peak of 950.82.

Meanwhile, I have been drawing attention to the massive new area of bearishness (black zone) which has been building all during 1971. Actually, there has not been a single month in 1971 in which the DSIR was above 1.0. This has never happened before in history. The latest reading on the DSIR (December) was a very low .50, a reading lower than anything seen during 1968, 1969 or 1970 (it was surpassed only twice in 1971).

Thus, from the standpoint of the DSIR the warning is loud and clear. The black area of below 1.0 which has appeared during 1971 is the largest and (presumably) the most bearish ever to present itself on the chart of the DSIR. The DSIR is saying that the Dow Industrial Average has little or no technical support from its short interest, and that the market is skating on very thin ice indeed.



SECONDARIES: The year 1971 went out establishing at least one new stock market record. That was for the number of secondary distributions within a single month (December). As mentioned many times previously, the secondary distribution is one method in which large interests dispose of massive blocks of stocks with minimum disturbance to the market. Secondary distributions must be registered with the S.E.C., and while they are being sold, the price of the stock in question may be "supported". This means that the market for the given stock will probably hold up, at least while the secondary is being distributed.

The accompanying chart shows the monthly totals of secondaries from 1965 to date. Note the major distributions during late-1968 and early-1969, as the market went into its worst plunge since the 1930's. Obviously, informed interests were taking advantage of

 the rally in the primary bear market and hundreds of secondary distributions were registered and sold.

The year 1971 has surpassed 1968-69 in the number of secondaries in various given months. During May, 1971, there was a record 44 secondary distributions and during June there were 43. July saw 38, and as the market slumped secondaries dropped off to a low of 18 in August.

But in September secondaries again jumped to 41, October saw 36, and November produced 42 secondaries. Finally, December, 1971, with its end-of-the-year rally seemed to have provided a golden opportunity for investors to put out secondary distributions. Last month (see chart), no less than 49 secondaries hit the market, the largest monthly total on record.

Thiskind of informed distribution does not bode well for Wall Street. It smacks of late-1968 early-1969, only more so.

THE PICTURE: Well, here comes 1972, marching in like a tiger, and except for a major part of the 30 million American stockholders who are still sustaining stock market losses on balance since the 1966 bull market top, nobody would believe that a primary bear market is really on.

The predictions for 1972 are glowingly bullish, so much so that the Wall Street Journal (December 29) noted that private economists are beginning to experience doubts about their widespread and almost unanimous bullishness. Alan Greenspan (a leading private economist, who happens to have President Nixon's ear) is quoted as saying, "The consensus forecast is a mile wide and an inch deep," and Mr. Greenspan admits that because of that he is "a little nervous".

Another economist who harbors doubts about the "rosy" state of the economy is Eliot Janeway, who, in his latest bulletin states: "I am lowering my sights on the U.S. economy — for the second time this year". I might add that around midnight (Christmas) my phone rang and the stentorian voice of Eliot Janeway rang out saying that he had just arrived with his wife at La Costa in Southern California, a place that had been recommended to him. "Where am I?" he asked. I told him he was about 20 miles north of La Jolla (did I ever tell you that Janeway is a most unorthodox person), and the next day I had the pleasure of visiting with the Janeways (his wife is Elizabeth Janeway, the well-known writer and critic). It was a most interesting visit, and our conversation ranged everywhere from women's lib and drugs to economics and politics.

In the course of our conversation Eliot noted (in the economic sphere, of course) that the peak of auto sales had passed, that Christmas sales (with many cut-rate prices) had been disappointing, phase 2 was bogging down completely, Europe is in an economic squeeze (with Japan wrecking the European price structure in its desperate urge to sell) and capital goods spending (one of the mainstays of any boom) is not slated for any great improvement in 1972.

But aside from Janeway, I really can't think of any other major economist who is not going along with the "new prosperity" consensus. This fact alone provides food for contrary thought. Behind it all, I believe, are the Administration's continuing efforts to "hype" the economy at all costs so that "boom times" will be assured by election day. The morality of this is highly questionable, both from the standpoint of inflation (robbing creditors and savers of U.S. dollars) and from the ethical standpoint when it comes to using the military as an instrument of employment.

It has been said that if unemployment is over 6% by election time, Mr. Nixon may have trouble winning, while if it is under 5%, unemployment will not be a major issue. Along these lines I include two news clips which I believe are most illuminating. One has to do with the impending saturation in the housing field, where frantic building efforts are literally choking the nation with houses of every conceivable variety. The other article deals with the question of military procurement, and here I leave my readers to draw their own conclusions. Lest there be any misconceptions, I might add that I have a

SATURATION THREATENS 1972 HOUSING INDUSTRY

NEW YORK (AP) — The limiting factor in the 1972 housing market may be lack of market demand rather than lack of mortgage money, the president of the National Association of Business Economists said Tuesday.

"If the production of new housing falls short of the 1971 record, it will be because market demand could not sustain two back-to-back two-million-unit years," said Saul B. Klaman, also chief economist for the National Association of Mutual Savings Banks.

In some areas of the country, he said, mortgage money may exceed demand as happened in the early 1960s when the quality of credit deteriorated. Such a situation underscores the need for restructuring of thrift institutions so they can provide a more stable flow of mortgage funds throughout the business cycle, he added.

Dependent on war

Milwaukee Journal

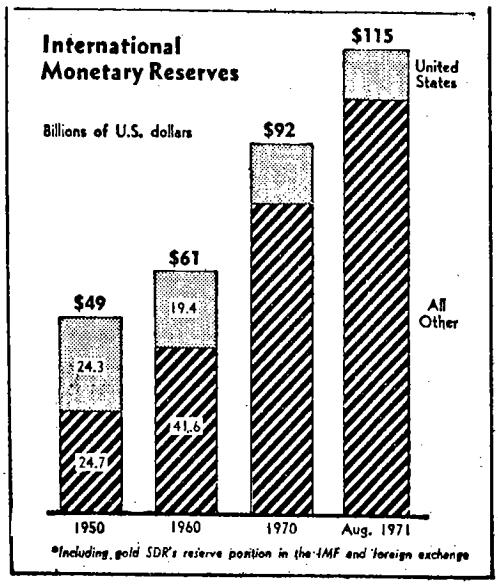
If you have doubted that this nation's priorities are in frightful disarray, the clincher should have been the explanation by the House Appropriations Committee last month when it approved $71 billion spending by the Defense Department in the current fiscal year—an actual increase of $1.5 billion despite the pullback in Vietnam.

A principal justification cited by the committee was to maintain employment in defense industries! That says in so many words that we have built an economy dependent on a war machine, and we're stuck with it, and don't dare come off it, because we can't think of any other way to keep all those people on payrolls.

An economy that has come to depend on a military foundation for its survival is in real trouble. For that output is all waste, creating nothing that builds the national wealth. It feeds on the productive sector of the economy as the only place where the money to support it can come from.

Congress isn't even dreaming in $71 billion terms of licking pollution, financing education, building houses, attacking poverty, enhancing the quality of life. It could get a good start on all that with one year's military appropriations.

great many military men on my subscription lists, from Generals and Admirals on down. I have found these gentlemen to be highly intelligent and in many cases brilliant thinkers, and I do not hesitate to include this article because I know that many of them are asking the same questions (ask any top military man about the little matter of waste in the services).



GOLD AND THE DOLLAR: Back in 1950 (see chart) the U.S. was the monetary power of the Free World. At that time the U.S. owned fully half the monetary reserves in the world, and because of this the U.S. was financially impregnable. Further, the U.S., as the rich and powerful "kingpin", gave the orders. The chart shows that the times have changed.

I will not go into the whole painful history again, but suffice it to say that 1971 was the year when the kingpin's money fell. It fell in an embarrassing way, because the U.S. happened to owe massive sums of money to nations all over the world. So out of this consternation came a plan. Mr. Nixon and Mr. Connally decided to renege on the U.S. debt (no gold, no dollar convertibility), and see what a little pressure could bring to bear. And lo and behold, it almost seemed as if the pressure was going to solve the problem. In the face of a 10% surcharge and a squeeze on European and Japanese exports, Mr. Connally succeeded in pressuring our creditors into making concessions.

The entire nation seems to be applauding the Connally-Nixon "coup" which resulted in revaluations of leading foreign currencies, a removal of the 10% U.S. surcharge, and a promised devaluation of the dollar (to $38 per ounce of gold). Congratulations flowed as U.S. businessmen and politicians the nation over lauded Mr. Connally's "toughness" and acuteness in forcing such outstanding concessions from the people we owe money to.

And the new $38 dollar price of gold, what does it mean? It doesn't mean a thing, except as a tacit admission that the dollar is still defined and valued in terms of gold and that the dollar was worth considerably less than what the U.S. insisted it was.

But wait a second. Something strange is happening. The U.S., in its vacuous triumph, has decided to put the price of the dollar at $38 to an ounce of gold (of course the U.S. is lying in its teeth and is scared to death of the real, free markets, since if the price of $38 was a fair and true price the U.S. would be buying and selling gold at that price. Actually, the U.S. won't sell gold at any price and can't possibly buy gold at $38 because there are no sellers at that fake price). But the strange thing which is happening threatens to throw the whole Nixon-Connally "triumph" into a cocked hat. What could it be?

It's nothing more than the free markets "talking". The highest one-day closing price for gold was $43.94 set in August just prior to President Nixon's August 15 speech. The highest weekly closing in history for gold was $43.40 on November 26, 1971. On January 4, 1972, gold closed at $44.37, a new record, 26% above the current $35 U.S. price for gold and 16% above the new (devalued) U.S. price of $38 per ounce of gold! (see page 6 chart).

Frankly, I did not expect the price of gold to start moving up this quickly. I was thinking in more orthodox terms of a second and then a third and fourth and fifth devaluation as the U.S. failed to get its house in order and as the rest of the Free World moved towards a greater realization that gold and only gold was to be the centerpiece of the new monetary system. But now, I am watching the marketplace, and that (like the tide) waits for no man. And the price of gold is starting to "blow", it is starting on the way to a possible rampage. It will probably carry silver with it (and I have been saying that the price of silver appears to be bottoming out . —See Letters 515 and 516).

What does it mean if gold starts roaring on the free markets? What does it mean if gold continues up as it has (since September, 1970, gold has been moving up at the rate of 14¢ per week). What will it mean if gold starts jumping at the rate of 30¢, 50¢ or $1 per week? It will mean that the whole negotiated settlement was a waste of time, an exercise in futility, a dream that didn't jell. It will mean that the market is saying that gold is going to roar towards its proper value (in the marketplace) as speculators, investors and central banks throw in paper for gold in a panic which will end in either total monetary chaos and collapse, or a system based on gold where no one nation can force its free-wheeling debt down the throats of other nations and where all debts are convertible and payable in the single reservoir of value which has stood up throughout the centuries, from Biblical days to today — gold.

Harry Browne, whose book, "How You Can Profit from the Coming Devaluation," became the talk of large and small investors last year, said the devaluation President Nixon agreed to in the Azores isn't the one he wrote the book about.

Reached in his Vancouver, B. C., home, where he is working on a new book, Browne said that a large devaluation of the dollar is still ahead and that it isn't too late for investors who share his analysis to take the steps he advocates as a defense against a large devaluation.

A devaluation of the dollar in terms of gold of less than 10 per cent, Browne said, is not large enough to bring about the needed results, and only serves as a public vindication of his prediction that the United States would have to hike the price of gold.

"Gold must go to $50 to $70 an ounce to put the international monetary system back in balance," Browne said. "It could be as little as $50 an ounce if it were coupled with the revaluation of other currencies, but it could also be that the gold would have to be priced between $70 and $100 an ounce to restore equilibrium."

He reasons that the U. S. will have to return to a convertible dollar, such as existed before President Nixon closed the gold window last Aug. 15. Under those arrangements, foreign central banks could demand gold in exchange for dollars they held.

Another Run on Gold

"If we were to return to convertibility at, say $40 an ounce, there would be another run on gold in no time at all," he contended.

But the stock market will fall apart when the depression becomes clearly visible, he predicted.

Has to Happen

Browne reasons that the depression has to happen because of the extent of the inflation that has existed in the country. He contended that government intervention in the economy can't prevent the business cycle from rising and falling.

"The only question is when, and I believe it [the downturn] has been going on for about a year," he continued. "You can see it in the failures of big companies, having to be bailed out at the expense of more efficient companies and pulling them down in a chain reaction."

He finds a further indication of a nearing depression in the "failure of the government to use the tricks it has used for the last 30 years to stimulate the economy."

"Of course, these tricks have their price in the long run, but previously they could produce short-term results," he said.

Specifically, he anticipates that unemployment and business failures will increase.

He explained:

"It should take about three years to get to the bottom of the economic trough and start the recovery, but with the power that the government has to interfere in the economy, it could really drag on. In my opinion, what we need is the most helpless individual in the world in the Presidency because the less the federal government does, the quicker we will be out of the coming depression."

Defensive Advice Varies

Browne's advice varies on how to protect one's assets from the twin horns of depression and devaluation, based on the objectives of the individual investor.

"If all you're after is safety of your principal, then buy a bag of silver coins and put the rest in a Swiss bank in Swiss francs," he advised.

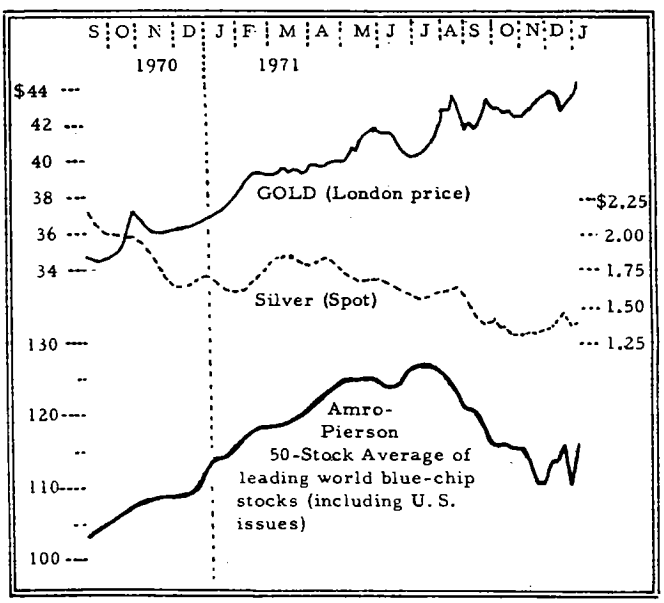
"If, on the other hand, you want to be a little more speculative and want to try to make a bundle, go into quality gold stocks."

He also said that he has been able to make money trading in currency futures, but stressed that that type of investment is very speculative and one wouldn't want to put any money there that he isn't prepared to lose.

In addition to his conclusion that a large-scale devaluation is a certainty, Browne said that the United States is in the early stages of a depression and that the economy will only get worse in the next three years.

"We are now in the beginning stage of a depression, comparable to 1929, and the apparent upturns will only be false signals," he said, noting that the current strong uptrend in the stock market is one of the false signals.

He said, however, the market could go even higher, depending on how expansive a monetary policy the Federal Reserve Board follows.



When I was a younger man I used to ponder over the ancient adage, "Gold will win". Win what, I would wonder, win over whom? It is clear to me now. Gold will always win over the cheats, the inflationists, the power-mad politicians, the half-baked neophyte economists, the men who promise something for nothing. The reason is that gold stands for something, it stands for intrinsic value. And the economists' debt-ridden plans and the politicians' promises stand for palliatives and lies to the people. But more and more it appears that we will all see the meaning of the adage, "Gold will win".

As I re-read this section I say to myself, "Russell, people will think you're crazy, they'll think you're a fanatic, a nut. How can you take a chance writing this sort of stuff and sending it to peaceful investors and market students throughout the nation and the world." Frankly, I could almost agree with those who say that I am "waking the dead", that I am "kicking a dead horse of gold". But then how do you explain the gold price chart on page 6? Is this part of my fantasy too?

I am reprinting the above article (by George Beardsley) from the Chicago Tribune of a few weeks ago, as I think it is of interest to all subscribers. The article was entitled, "Brown Predicts Big Devaluation".